No. 402

IN THE

Supreme Court of the United States

October Term, 1963

J. I. CASE COMPANY, HARRY G. BARR, JOHN T. BROWN, L. R. CLAUSEN, WM. J. GREDE, E. P. HAMILTON, WM. B. PETERS, and MARC B. ROJTMAN,

Petitioners,

vs.

CARL H. BORAK, for and on behalf of himself and all of the other common stockholders of J. I. Case Company who are similarly situated to him,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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BRIEF FOR J. I. CASE COMPANY

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OPINIONS BELOW

The opinion of the United States Court of Appeals for the Seventh Circuit is reported at 317 F. 2d 838. The opinion of the United States District Court for the Eastern District of Wisconsin is not reported, but is set forth at page 200 of the Record.

JURISDICTION

The judgment of the court of appeals was entered on May 29, 1963. The petition for a writ of certiorari was filed August 26, 1963, and was granted on November 12, 1963 (84 S. Ct. 195). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

I. Did the Court below err in holding that there is a private right of action for damages or other retrospective relief under Sections 14(a) and 27 of the Securities Exchange Act of 1934 for use of false and misleading proxy material?

II. Did the Court below err in refusing to apply the Wisconsin security for expenses statute, even if such an action is held to lie?

STATUTES INVOLVED

Pertinent provisions of the Securities Exchange Act of 1934 (15 U.S.C. §78) are set forth as Appendix A. Section 14(a) (15 U.S.C. §78n) provides:

> "(a) It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of any national securities exchange or otherwise to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered on any national securities exchange in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

The Regulations prescribed by the Securities and Exchange Commission under Section 14(a) are set forth as Appendix B.

The Rules of Decision Act (28 U.S.C. §1652) provides:

> "*State laws as rules of decision.* The laws of the several states, except where the Constitution or treaties of the United States or Acts of Congress otherwise require or provide, shall be regarded as rules of decision in civil actions in the courts of the United States, in cases where they apply. June 25, 1948, c. 646, 62 Stat. 944"

Section 180.405(4) Wisconsin Statutes provides:

> "(4) In any action brought in the right of any foreign or domestic corporation by the holder or holders of less than 3 per cent of any class of shares issued and outstanding, the defendants shall be entitled on application to the court to require the plaintiff or plaintiffs to give security for the reasonable expenses, including attorney's fees. The amount of such security may thereafter from time to time be increased or decreased in the discretion of the court having jurisdiction of such action upon showing that the security provided has or may become inadequate or is excessive."

STATEMENT

On or about September 6, 1956, the boards of directors of J. I. Case Company (Case), a Wisconsin corporation, and American Tractor Corporation (ATC), a New York corporation, approved a plan for merger pursuant to the Wisconsin Corporation Law. (R. 3, 21) Case, a major producer of farm equipment, had its common stock listed on the New York Stock Exchange. (R. 24) Common Stock of ATC, a small but growing manufacturer of crawler tractors and other light earth-moving equipment, was traded on the American Stock Exchange. (R. 24) Pursuant to the plan of merger, Case common stock and a new Case preferred stock were exchanged for ATC stock at a rate which approximated the relative stock market valuations of the respective common stocks at that time. (R. 27)

This lawsuit arose out of plaintiff's dissatisfaction with the merger as proposed in the fall of 1956. The plaintiff owned 2,000 of the 2,262,766 shares of Case common stock outstanding. (R. 1) From and after the middle of September 1956, some two months before the Case stockholders' meeting, the plaintiff and his attorney were in frequent communication with Case regarding the merger. Case cooperated fully, even furnishing the plaintiff with a special mailing of the Proxy material and a certified list of Case shareholders. (R. 88)

Proxy material describing the proposed merger was not challenged by the Securities & Exchange Commission and was mailed to Case shareholders on October 15, 1956. (R. 87) Since the shareholders' meeting to consider the merger was scheduled for November 15, 1956, the plaintiff still had a month in which to bring the allegedly false and

misleading proxy statement to the attention of the Commission and enlist its power to compel a correction of the proxy statement before the proxies given pursuant thereto were used. (R. 87) The complaint and all subsequent pleadings are silent as to why the plaintiff elected not to pursue this remedy. Instead, the plaintiff commenced this suit in the Eastern District of Wisconsin on November 13, 1956, and defendant Case was served November 14, 1956, only one day before the meeting at which the Case stockholders considered the proposed merger. (R. 88) Among other things, the plaintiff alleged in his complaint that false statements had been made in the proxy statement (R. 6); that the book value of Case common stock would be diluted (R. 7); that the merger was against the best interests of the Case stockholders (R. 8); that stock was being issued for less than par value (R. 10); that the stock and assets of ATC were over-valued by the Case directors (R. 11); and that he had no adequate legal remedy (R. 15). The plaintiff sought to enjoin the merger and moved for a temporary restraining order. (R. 16). At the time of the merger Case had 8,241 common stockholders. Since much Case stock was owned in street name by brokerage firms, the number of beneficial shareholders was much higher. No other stockholder has joined with the plaintiff or challenged the legality of the merger in any other proceeding.

In its written order entered November 29, 1956, denying the plaintiff's application for a temporary restraining order, the district court held, *inter alia*, that there was no evidence that the merger was illegal or fraudulent or that it would irreparably damage the plaintiff (R. 88); that the plaintiff had failed to do equity in not making more timely application (R. 88); and that the right of appraisal (Sec-

tion 180.69 Wisconsin Statutes, see Appendix C), an integral part of the Wisconsin merger statutes, afforded the plaintiff an adequate remedy at law. (R. 88). This denial was not appealed.

The plan of merger was approved by 91.8% of the common stockholders present and voting at the meeting of November 15, 1956, and the merger was consummated January 10, 1957. (R. 106)

Case acted to bring the action speedily to trial but extensive discovery proceedings intervened. (R. 154). Following this period of discovery, the plaintiff filed his first amended and supplemental complaint on April 1, 1958, adding 29 additional defendants. (R. 111) This complaint reiterated the allegations of fraud (R. 140) and breach of fiduciary duty (R. 126) of the original complaint, as well as re-alleging that plaintiff represented a class. (R. 112) For relief the plaintiff prayed that the merger be declared void, that Case be divested of ATC, that persons who received Case shares pursuant to the merger be made to surrender them, that new shares be issued, and that other appropriate equitable relief be granted. (R. 143-145)

On April 7, 1958, Case moved for security for expenses under §180.405(4) Wis. Stats. (R. 153) On October 23, 1958, the court ordered the plaintiff to post security for expenses in the amount of $75,000, but upon plaintiff's application granted leave to amend the complaint so as not to come within the Wisconsin statute. (R. 151) However, the plaintiff failed either to amend or post security, and the court granted Case's motion to dismiss on September 17, 1959. (R. 153)

Since that date, the history of this action consists entirely of the plaintiff's efforts to avoid posting security for expenses by successive revisions of his complaint without, however, alleging any new material facts.

The District Court saw through these attempts but on each application permitted the plaintiff every opportunity to replead. Pursuant to Rule 60(b)(6) of the Federal Rules of Civil Procedure, on March 10, 1960 the court vacated its judgment of dismissal so that the plaintiff could file a second amended and supplemental complaint. (R. 158) The plaintiff filed this complaint, his third in the case, on July 1, 1960. (R. 160) Again purporting to represent all Case shareholders similarly situated (R. 160), the plaintiff reiterated his claims for fraud and breach of fiduciary duty (R. 167).

For the first time, some three and one-half years after the merger, plaintiff claimed deprivation of his pre-emptive rights (R. 163) and asserted a right to retrospective relief under the Securities Exchange Act of 1934 (hereafter called "the Act") (R. 162, 176) The plaintiff prayed for damages from the Case directors and others and equitable relief to undo the events of the past four years, including a decree ordering Case to issue new stock to the plaintiff and fellow members of his class so as to compensate for the violation of pre-emptive rights, and a declaration that the merger and all agreements made pursuant thereto were void. (R. 176)

Case again moved for security for expenses and the court ordered the plaintiff to file a third amended and supplemental complaint (hereafter called "the Complaint") separating his cause of action based on diversity from his cause of action based on claimed violations of Federal laws. (R. 178) On January 12, 1962, the plaintiff did file such a complaint, (R. 179) his fourth in this action. The District Court found that Count I of the third amended and supplemental complaint alleged the same facts to which the court previously had applied the Wisconsin security for expenses statute. (R. 208)

Count II asserted claims under both Section 10(b) and Section 14(a) of the Securities Exchange Act. (R. 197) The District Court held that the allegations as to 10(b) were surplusage and inconsistent with the other allegations of fact of the complaint, and that it had jurisdiction only to render a declaratory judgment as to violations of 14(a), and could grant retrospective relief under Wisconsin Law, but not under 14(a). (R. 211, 212) To the extent Count II prayed relief other than a declaratory judgment the court held that it stated a derivative cause of action under Wisconsin law, which made it subject to the Wisconsin security for expenses statute. Accordingly, the District Court ordered the plaintiff again to post security in the amount of \$75,000, pursuant to §180.405(4) Wisconsin Statutes. (R. 212) Again the plaintiff failed to comply with the order of the court and, on October 1, 1962, the District Court ordered the third amended and supplemental complaint dismissed, except to the extent Count II might be construed as a suit for a declaratory judgment. (R. 214, 215) The plaintiff thereupon took an interlocutory appeal to the Court of Appeals for the Seventh Circuit. (R. 216)

The Seventh Circuit decided three questions. First, it held that the Wisconsin security for expenses statute did not apply to Count I because that Count stated a non-derivative cause of action. (R. 227) Second, it affirmed the holding of the District Court that Count II did not state a cause of action under Section 10(b) of the Act. (R. 229) Third, it held that the Wisconsin security for expenses statute did not apply to Count II. (R. 234) The Seventh Circuit reasoned that the state statute was inapplicable because a federally-created private action exists for retrospective relief for violations of Section 14(a) of the Act. (R. 234) Pursuant to these findings, the Seventh Circuit reversed the order dismissing the plaintiff's third amended and supplemental complaint. (R. 234, 235)

SUMMARY OF ARGUMENT.

The corporate defendant, J. I. Case Company, is not the nominal party characteristic of cases of this nature. It represents the thousands of stockholders who approved this merger and whose money over the past seven years has been invested in the merged enterprise and who would be materially prejudiced if the plaintiff were to prevail in having the merger declared void. The Company's present position in the case and on this appeal reflects the interests of its stockholders only. The present management of the Company is independent of the individual defendants who were directors at the time of the commencement of the suit. None of the present executives of the Case Company has ever been a defendant in this action. The only present Case director who has ever been a defendant is Mentor Krause, who was formerly the attorney for ATC.

J. I. Case Company actively sought in the District Court the security bond provided for by Wisconsin law and pressed this appeal because, under Section 180.407 Wisconsin Statutes, the Company will be required to reimburse the director-defendants for their legal expenses if they are successful in defending the case.

The Seventh Circuit reversed the order of the Eastern District of Wisconsin, which had dismissed the third amended and supplemental complaint for plaintiff's failure to post the required security for expenses. The Seventh Circuit held that because Count II stated a federally-created action, the Wisconsin security for expenses statute should not have been applied by the District Court. J. I. Case Company contends that the Seventh Circuit erred both in holding that a federally-created action exists for violations of Section 14(a) and in holding that the Wisconsin security for expenses statute does not apply if the action is federally created.

The federal cause of action which the plaintiff attempts to assert does not exist. The Securities Exchange Act does

not create a private action for retrospective relief for violations of Section 14(a), either expressly or impliedly. The failure of Congress to provide for such an action must be interpreted as a manifestation of its intention that there should be no such action. The scheme of the Act is to provide before-the-fact policing of proxy solicitation and the limited civil liability created by Section 18(a) for proxy rule violations. Congress did not create a new federal private action for retrospective relief because it recognized that shareholders who are harmed by fraudulent proxy solicitation have adequate remedies, including retrospective relief, under state laws of fraud, misrepresentation, and breach of fiduciary duty.

Under the Securities Act every means is afforded shareholders to obtain full disclosure in advance of corporate action. The Act authorizes the promulgation of proxy rules and it provides for the advance clearance of proxy material by the Securities and Exchange Commission and for court action to bar the use of proxies or the holding of a stockholders' meeting based upon a materially false and misleading proxy statement. We do not question the private right of shareholders under the Act, in addition to the rights of the Commission, to seek prospective relief of injunction in such circumstances.

On the other hand, to sanction a new Federal cause of action for retrospective relief, where appropriate remedies already exist under state-based law in the event of fraud or breach of fiduciary duty, would be an unwarranted extension of Federal jurisdiction. It would create difficult problems in accommodation of State and Federal law and would force Federal courts to deal with the internal affairs of corporations, which traditionally have been governed by the law of the state of incorporation and have been the responsibility of the state courts.

Sanction of the action requested by the plaintiff, simply to allow him to escape the state security for expenses statute, is unjustifiable on principle and as a practical policy.

Even if a federal cause of action for retrospective relief for violations of Section 14(a) were created, the Wisconsin security for expenses statute should still be given full effect.

Federal law is interstitial in character. This is acknowledged by recent decisions of this Court, the commentators, and the Rules of Decision Act. This Act provides that state law shall govern in civil actions in the federal courts where applicable, unless the federal Constitution or treaties or Acts of Congress require or provide that state law shall not control. That it is a basic prerogative of the states to regulate corporate affairs, including internal shareholder-management relations, has long been recognized in diversity cases. This state prerogative remains effective despite the fact that the right asserted is federal in origin.

The Rules of Decision Act establishes a guide for accommodating state and federal law; it embodies a judgment that federal law should not displace any more state law than is necessary to accomplish the federal policy involved. It follows that the Wisconsin statute should be applied in this case unless it is inconsistent with the policy of the Securities Exchange Act or some other federal law.

This Court has already held that state security for expenses statutes are not inconsistent with the policy of Rule 23(c) of the Federal Rules of Civil Procedure. Neither is the Wisconsin statute inconsistent with the policy of the Securities Exchange Act. In Section 18(a), which explicitly provides a far less drastic liability for use of a false and misleading proxy statement than the plaintiff here demands, Congress furnished its own security for costs provision. Since every indication of federal policy strongly favors security for expenses, it was error for the Seventh Circuit not to enforce the rights conferred upon corporate defendants by the Wisconsin security for expenses statute.

ARGUMENT.

I.

THE COURT BELOW ERRED IN HOLDING THAT THERE IS A FEDERALLY-CREATED PRIVATE ACTION FOR RETROSPECTIVE RELIEF FOR VIOLATIONS OF SECTION 14(a) OF THE SECURITIES EXCHANGE ACT.

A. The Failure of Congress to Create a Federal Right of Action for Retrospective Relief for Violations of Section 14(a) Was Intentional.

Section 14(a) of the Securities Exchange Act (15 U.S.C. §78n) proscribes proxy solicitation in contravention of the rules which the SEC is authorized to make. The Act gives the SEC power to enforce its rules, either prospectively by injunction or retrospectively by criminal action. It does not contemplate private enforcement for retrospective relief.

On its face, Section 14(a) is a typical regulatory statute. It should be construed in the same manner as other such statutes, for example the Federal Safety Appliance Acts.

> "When Congress in the Safety Appliance Acts imposed only penal sanctions for the observance of statutory safeguards enacted broadly for the protection of railway employees, passengers, and even travelers at crossings, and in a related act (the Employers' Liability Acts) created a private right of action only in employees engaged in interstate commerce, as defined, fairly obviously it cannot be maintained as a matter

of statutory interpretation that Congress has also created a statutory right of action in favor of intrastate employees, or passengers, or travelers at crossings, injured as a result of violation by the railroad of the Safety Appliance Acts."

Jacobson v. *New York, N.H. & H.R. Co.*, 206 F. 2d 153, 156 (1st Cir. 1953), Magruder, J., aff'd *per curiam*, 347 U.S. 909 (1954). For similar treatment of the application of Clayton Act civil remedies to Section 3 of the Robinson-Patman Act, see *Nashville Milk Co.* v. *Carnation Company*, 355 U.S. 379 (1958), Harlan, J.

The Safety Appliance Acts decisions are analogous to this case. Like the Safety Appliance Acts, Sections 9(e), 16(b), and 18(a) of the Securities Exchange Act expressly provide private remedies. Section 9(e) (15 U.S.C. §78i) makes willful manipulators of security prices liable in damages to persons who have purchased or sold a security at a manipulated price. This Section is clearly inapplicable here. Section 16(b) (15 U.S.C. §78p) makes the profits of "insider" speculation recoverable by the issuer. This Section also does not apply to this case. Section 18(a) (15 U.S.C. §78r) gives the right to recover damages to persons who, in reliance upon a knowingly false and misleading proxy statement, purchase or sell a security at a price which is affected by the statement.

The plaintiff in the instant case does not come within the class of persons entitled to damages under Section 18(a), because he did not buy or sell in reliance upon a false or misleading proxy statement. Traditional methods of statutory construction, particularly the rule of *expressio unius*, completely negate any inference that the Act was intended to create a private civil remedy for violations

of Section 14(a). In enacting Section 18(a), Congress certainly realized that shareholders in a company which is party to a merger would also be injured by fraudulent proxy solicitation. Since no express or implied provision was made in either Section 14(a) or Section 18(a) for the relief of such shareholders, the legislative intent was clearly to leave the remedy for such injuries to the common law, which has traditionally furnished relief from fraud and breach of fiduciary duty. This conclusion was reached by Judge Medina in *Howard* v. *Furst*, 238 F. 2d 790, 793 (2d. Cir. 1956).

> "We find nothing in the language of Section 14(a) or in the legislative history of the Securities Exchange Act of 1934 to warrant an inference that it was the intention of the Congress to create any rights whatever in a corporation whose stockholders may be solicited by proxy statements prepared in contravention of the statutory mandate.
>
> "Ambiguous or equivocal language would hardly be sufficient to support an innovation of such far reaching effects. Lauritzen v. Larsen, 345 U.S. 571, 73 S. Ct. 921, 97 L. Ed. 1254. Here the statute authorizes the formulation of rules and regulations 'in the public interest or for the protection of investors.' There is literally nothing to support the view that any substantive rights were created for the benefit of the corporation.
>
> "The Securities Exchange Act of 1934 is a comprehensive piece of legislation of wide scope. Significantly, where it was intended to create a right of action in favor of the issuer corporation, the statute makes express provision therefor, as in the case of Section 16(b), 15 U.S.C.A. §78p(b), relative to short-swing profits. And see Birnbaum v. Newport Steel Corp., 2 Cir., 193 F. 2d 461, certiorari denied 343 U.S. 956, 72 S. Ct. 1051, 96 L. Ed. 1356."

The Seventh Circuit, in declaring the existence of a federal private action, relied upon *Bell* v. *Hood,* 327 U.S. 678 (1946):

> "For the achievement of that purpose, the jurisdiction conferred by Section 27 must be broad enough to effectively protect that right. Thus, it is said in Bell v. Hood . . . that federal courts have the power, *under a general grant of jurisdiction to enforce a federal statute,* to grant all the relief which may be commensurate with the effective enforcement of the statute and the protection of the rights created thereby, notwithstanding failure of the statute to specify the remedies which may be employed." (R. 233, emphasis supplied.)

We submit that this application of *Bell* v. *Hood* was erroneous, because Section 27 (15 U.S.C. §78aa, see appendix A) is not a "general grant of jurisdiction" to the courts to enforce the Act, but merely a designation of the forum. Section 27 does not itself create any liabilities, but simply tells persons who wish to enforce liabilities which the Act has created that they must sue in federal court.

> "The (Securities Exchange Act) does have a general provision on jurisdiction, venue, and service (Section 27) to take care of *actions by the Commission and the private actions expressly created by the statute.*"

Loss, "The SEC Proxy Rules and State Law," 73 Harv. L. Rev. 1249, 1270 (1960), emphasis supplied.

There are many reasons why Congress did not create a new federal private remedy for retrospective relief for violations of Section 14(a), and why the Courts should not speak where the legislature was silent. These reasons will be developed hereinafter. Suffice it for the present to say that Congress intended to create no new action for such violations.

B. Creation of a Federal Private Action by the Court Would Not Contribute to the Effective Enforcement of Section 14(a).

The axiom that every right has a remedy does not answer the question which the instant case presents. Here the issue is not whether there is to be a remedy, but whether there is to be a new federal remedy duplicating the existing state common law and statutory remedies. Even if the *Bell* v. *Hood* principle were applicable, the Seventh Circuit's opinion concedes that the Court could properly create a new civil remedy for violation of Section 14(a) only if "effective enforcement of the statute and the protection of rights created thereby" require it. (R. 233). Thus the decision whether or not to create a private action, even under the approach taken by the Seventh Circuit, must be based upon an appraisal of policy considerations.

> "When neither the statute nor the common law authorizes an action and the statute does not expressly deny it, the court should first realize that *it* is being asked to bring into existence a new type of tort liability on the basis of its appraisal of the policy considerations involved.
>
> * * *
>
> "Even when . . . countervailing policies are absent, a court should not analogize blindly and make tortious all conduct which the statute denounces as criminal. A court may well be justified in granting a civil remedy only for an intentional or negligent invasion of the protected interest where the criminal liability imposed by the statute is absolute."

Note, "The Use of Criminal Statutes in the Creation of New Torts," 48 Col. L. Rev. 456, 459 (1948), emphasis supplied.

The Seventh Circuit seems to have assumed on faith that a private action here would be a good thing. While acknowledging that policy considerations must be appraised, the Seventh Circuit's opinion is completely devoid of any analysis of the countervailing factors involved in creation of the federal private action demanded by the plaintiff. Examination of this aspect of the problem will reveal that neither justice nor policy reasons favor creation of such a federal action. Creation of a private action would not assist at all in the effective enforcement of Section 14(a). Moreover, it would have many highly undesirable effects, especially if retrospective relief is allowed.

The purpose of Section 14(a) and the rules thereunder is to increase the effectiveness of Securities & Exchange Commission surveillance over the use of proxies, that is, to prevent fraudulent use of the proxy device in its inception. The single basic duty promoted by all the procedural safeguards of 14(a) and the Rules, is the duty not to defraud; the scheme of the statute is not to abandon the common law standard, but to strengthen it by requiring full disclosure of all material facts in proxy statements. To accomplish this, injunction proceedings were created by the Act. (15 U.S.C. §21, see Appendix A). Except for the purpose of implementing the policing function of the Commission, no new duties were created by the Act. The fact that the Proxy Rules apply only to those corporations subject to the Act is conclusive that their function is to aid the SEC rather than to change the primary right-duty relationship of shareholders and proxy solicitors in general.

In creating the Securities & Exchange Commission for preventive regulation, Congress apparently recognized the enormous problems which arise in framing retrospective relief (see p. 19). The federal criminal sanctions, (15

U.S.C. §78ff, see Appendix A), the complete state-based remedies, and the policing powers granted the Commission serve as an adequate deterrent to violations of the Rules.

The gravamen of a shareholder's complaint for retrospective relief must be fraud, misrepresentation, breach of fiduciary duty, or the like. Not only is there no need for a new federal private action, but such action, if created, would have to measure the allegations by traditional state-based standards of conduct. As Judge Dimock has so aptly observed:

> "Even plaintiffs concede that if the Proxy statement were followed by a fair exchange the directors would not be liable to the corporation. Also, it is clear that, had the proxy statement been perfectly lawful but followed by an unfair exchange, the directors would be liable for damage sustained and profits realized in violation of their fiduciary duties."
>
> ". . . Since the liability asserted by plaintiffs may be proved without regard to the proxy statements and cannot be proved without regard to the alleged breach of fiduciary duty it is impossible to say that plaintiffs are asserting a right under or created by a federal law. The allegations as to the proxy statement are either mere surplusage or a mere pretext for assertion of federal jurisdiction."

See *Lapchak* v. *Sisto*, CCH Fed. Sec. L. Rep., Par. 90, 721 (S.D.N.Y. 1955), Dimock, J.

See also the language of Judge Medina in *Howard* v. *Furst*, 238 F. 2d 790, 794 (2d Cir. 1956):

> "The allegations with reference to the proxy statement constitute a mere excresence or superfluity, tacked onto what are otherwise sufficient allegations of a claim for relief under New York law."

The simple fact that proxies may be involved does not justify transferring a fraud action from state law to the exclusive jurisdiction of the federal courts.

C. Creation of a Federal Private Action by the Court Would Have Many Adverse Consequences.

Creation of a private action for violation of Section 14(a) would open up a large area, now totally devoid of any guidelines, which would have to be occupied by federal common law. At present, persons harmed by fraudulent proxy solicitation have their remedy under a body of law the sources of which are state-based. Section 14(a) and the proxy rules lie superimposed upon this body of law. See Loss, "Securities Regulation" (2d Ed. 1961) p. 973. The existing remedial system is a comprehensive one, having grown with common law vitality. The departure urged by this plaintiff, besides inviting chaos in the entire area, runs counter to the basic principle of our federal system, which traditionally classifies federal law as interstitial in character. See Hart, "The Relations Between State and Federal Law," 54 Col. L. Rev. 489 (1954). Federal law should properly be extended only into those areas which are appropriate by reason of a need for uniformity or some other distinctly federal policy. No such policy appears in favor of the extension of federal law into the remedial aspects of proxy law. The legislative scheme of the Securities Exchange Act, which is preventively oriented, is satisfied without this extension. The problems of the federal system are among the most difficult and numerous facing the courts today; they should not be multiplied simply to allow plaintiffs to escape state security for expenses statutes. Unwarranted extensions of federal law of this nature have a debilitating effect on the vitality of the federal system and are undesirable and improper *per se*. *Dann* v. *Studebaker-Packard Corporation*, 288 F. 2d 201 (1961), Boyd, J., noted this effect and held that no

federal action would lie for retrospective relief for violations of Section 14(a):

> "... should we hold that the federal courts have jurisdiction, quite apart from diversity of citizenship, to determine matters of state law which are wholly independent of the federal issues before the Court, we would erode even further the equally vital principle of separate sovereignties which underlies the Constitutional and statutory definitions of 'the judicial power of the United States.' Furthermore, in these days of already overburdened federal trial dockets, it might well be a disservice to the federal judiciary to extend its domain into an area so predominantly governed by state and local law. This, we are unwilling to do." 288 F. 2d 201, 214 (1961).

The practicalities of the situation bear this out. Great and unnecessary problems of federal corporation law will be created. The initial problem is how much of the field to occupy. How much existing state-based law of corporations, fraud, and fiduciary relationships is to be abrogated? Proxy solicitation is necessarily very closely interrelated with fundamental corporate transactions. Proxies are an integral part of the voting mechanism of publicly held corporations, and shareholder approval is required by state laws for mergers, dissolutions, reorganizations, large purchases or sales of assets and the like, not to mention elections of directors. If retrospective relief of the sort demanded by this plaintiff is to be available for any alleged violation of the Act, the legal incidents of all these transactions will be affected.

Except as affected by government antitrust suits, the validity of these vital corporate transactions is today entirely determined by state law. Great uncertainty would follow the creation of a federal private action such as is urged here. Two bodies of law would be involved in every

fundamental corporate transaction, one having displaced the other to an unknown degree. Although the common law is most adept at growth through elaboration, that process depends upon the existence of background law upon which to elaborate. Creation of the action urged here would leave a large area which could only be developed in a random manner as the cases happened to present themselves.

The nature of the action created would contribute a great deal to this uncertainty. Until this Court has indicated in an appropriate case that civil liability would not extend beyond the criminal liability expressly created by Section 32 of the Act, that is, that there would be no civil liability for unintentional non-compliance with the Act or the rules, public corporations, which must make use of proxies, will live in a state of uncertainty. Even to clear up this point would not greatly improve the situation, since the need to prove willfulness would probably be a slight obstacle for a private litigant, who does not have to meet the same standards of persuasion which safeguard the criminal defendant. See Loss, *Securities Regulations*, 946, Note 348, and 1039 (1961). To further complicate the problem, no effective limitations period is provided by the statute. Should state limitations periods be borrowed? If so, from which state? It is argued *infra*, p. 28, that state security for expenses statutes should be borrowed. Should an appraisal statute which is an integral part of the state merger law under which the merger was consummated be applied, or may the federal court ignore it? Will the defenses available at common law or equity retain their validity? Will class actions lie?

In addition to problems of defining the extent of preemption, the federal courts would be required to interpret a great deal more state law because of the interrelation of proxies and other corporate law and the doctrine of pen-

dent jurisdiction. Problems of accommodation would be rife. The issue of when to interpret state law and when to pre-empt it with federal law would be persistent.

Jurisdictional problems would multiply. Under the theory the Seventh Circuit applied, the federal courts would be given exclusive jurisdiction over the private action sought to be created. Would the plaintiff be barred from suing in state court for common law fraud because his complaint recites a violation of the proxy rules? If this were so, the greatest degree of pre-emption would be realized. If not, the chief result would be to create additional opportunities for forum-shopping, which would result in the creation of further chaos in the law of proxy solicitation. If the plaintiff were not allowed to sue in state court for common law fraud, would not the jurisdiction of the state court to construe its own corporate statutes be completely abrogated? These and other questions will remain open, to add to the uncertainty, until this Court has heard a number of cases on appeal from the highest courts of the states. Even after that, virtually every case involving proxy solicitation will present one or more questions potentially reviewable of right by this Court. Thus the case load of the federal judiciary will be increased in two ways. Actions under the new liability will be presented to the trial courts while many questions appealable to this Court will be created in state courts.

Even more baffling problems might arise if it were held that Section 27 does not confer exclusive jurisdiction on the federal courts. In such event, the burden of more elaboration is thrust upon the entire judicial system, state as well as federal. If the action were held to be based on the general common law of the states, virtually nothing would be gained but trouble, as the state courts could be expected to continue to apply their existing standards.

If it were held to be a federal common law question, the same substantive problems would exist for the courts, plus some very bothersome jurisdictional ones. Exclusive jurisdiction might or might not obtain, so that state courts might often be asked to enforce the federal common law liability. Whenever they did, more reviewable questions would arise; the task of maintaining uniformity, which would then be the duty of this Court, might prove formidable.

The plaintiff's complaint asks that the merger, which was consummated in 1957, be declared void. (R. 197) Plaintiff takes the extreme position that Section 29(b) of the Act (15 U.S.C. §78cc, see appendix A), which declares contracts made in violation of the Act or the Rules "void," makes this entire merger automatically void. The merger agreement entered into under Wisconsin law was not in any sense made in violation of the Act or Rules. Moreover, such an extraordinary upsetting of a corporate structure is possible today only for antitrust violations, and, significantly, only when the antitrust suit is initiated by the Justice Department. It is worth noting that even though Section 16 of the Clayton Act (15 U.S.C. §26) expressly confers upon private plaintiffs the right to sue for injunctive relief for violations of the antitrust laws, the courts have uniformly refused to grant mandatory injunctions for divestiture, dissolution, and the like at the instance of private plaintiffs. Yet this plaintiff claims such a right to himself where there is no statutory grant of any private remedy.

If corporations which merge are not to be unscrambled, a federal doctrine of *de facto* corporate transactions will have to be developed. If the court decides no mandatory equitable relief is available, what is left for plaintiffs? Damages will be derivative in virtually every case, unless nominal damages are to be allowed the individual shareholder for violations of the proxy rules. If the sharehold-

er suffers any other compensable injury, what is it and how is it to be measured?

If a federal private action is to be implied, to what extent will the traditional defenses be available? For example, the defense of *volenti non fit injuria* seems to apply to a shareholder's suit of this kind. Where there is any sort of a market for the securities of the company involved, which there is for virtually every public corporation, the disgruntled shareholder can easily get his money out of the corporation through the market, or by use of the dissenting shareholder's right of appraisal. (Section 180.69, Wisconsin Statutes). This appraisal right is an integral part of the Wisconsin merger statutes, pursuant to which this merger took place. Most other states have similar provisions in their merger statutes. Where the price of the shares has risen after a transaction which results from an allegedly invalid proxy solicitation, the investor in a public corporation has not been injured. As Appendix D shows, the price of J. I. Case Company common stock, which is traded on the New York Stock Exchange, rose steadily for some three years following the merger. Thus the plaintiff could have made a profit over the price prevailing before the merger by merely calling his broker.

The burden on the Commission would be greatly increased by allowing private actions, since the application of the proxy rules would surely become confused under a barrage of strike suits in diverse courts throughout the land. A haphazard, random pattern would emerge where now there is comprehensive and effective regulation. The Commission would no doubt feel compelled to observe a great number of lawsuits, and to file *amicus* briefs in many of them in an effort to fulfill its regulatory duty. An additional problem for the courts and the Commission would be what effect, if any, to give Commission clearance of a proxy statement in subsequent private litigation brought to enforce the new liability.

The effect on corporations must be considered as well as the problems created for the courts. In an area which demands great certainty, corporate decision-makers would be forced to work without any guidelines to actions. To render a merger void, a plaintiff with the priceless advantage of hindsight would only have to show the omission of one material fact in a proxy statement, notwithstanding that thousands of other material statements were correctly set forth. This would place corporate planners in an impossible situation. Moreover, District Courts would have the power and obligation to remodel mergers long after their consummation, in accordance with their particular views of equity and finance.

The effect on corporate financing would certainly be adverse. The overhanging threat of divestiture or other equitable relief would make normal financing unavailable to any newly-consummated merger. At the very least, money markets and securities exchanges would thus be afflicted with an inherent instability. The use of proxies is essential to the continued healthy existence of public corporations in our economy; creation of the action demanded by this plaintiff would greatly impair if not destroy their usefulness.

It is also clear that strike suits would be greatly encouraged, especially if security for expenses is not to be demanded. The very reason for enactment of security for expenses statutes has been to curb the alarming increase of strike suits in recent years.[1] It would be a step backward to permit a new type of action without the accompanying restraint which has been found so necessary.

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[1] See Wood, Survey and Report Regarding Stockholder's Derivative Suits (New York State Chamber of Commerce 1944). On the ambivalent nature of minority shareholders' suits in general, see also the opinion of Judge Wyzanski in *Levitt* v. *Johnson*, CCH Fed. Sec. L. Rep., Par. 91,304 (D. C. Mass. 1963).

II.

THE WISCONSIN SECURITY FOR EXPENSES STATUTE APPLIES EVEN IF A PRIVATE ACTION FOR RETROSPECTIVE RELIEF FOR VIOLATIONS OF SECTION 14(a) OF THE SECURITIES EXCHANGE ACT IS CREATED.

Even if Count II does state a federally-created claim for retrospective relief, the claim it states is derivative, as the Seventh Circuit seemed to realize. Since the claim is derivative, the Wisconsin security for expenses statute must be applied.

Unless the plaintiff is contending only for nominal damages for a technical violation of his rights, the gravamen of his complaint must be injury to the corporation.

> "The action is derivative, *i.e.* in the corporate right, if the gravamen of the complaint is injury to the corporation, or to the whole body of its stock or property without any severance or distribution among individual holders, or if it seeks to recover assets for the corporation or to prevent the dissipation of its assets.
>
> ". . . If damages to a stockholder result indirectly, as the result of injury to the corporation and not directly, he cannot sue as an individual."

Fletcher Cyc. Corp. (1961 Rev.Ed) §5911, at p. 370.

Since *Smith* v. *Hurd*, 53 Mass. (12 Met.) 371, (1847), it has been uniformly held that damages to corporate assets are not injuries in the first instance to shareholders.

> "The basic criterion for determining whether an action is individual or derivative should be the impact of the alleged injury on the corporation."

Note, "Developments in the Law—Multiparty Litigation in the Federal Courts," 71 Harv. L. Rev. 874, 943 (1958).

The same note also lists the following as typical derivative actions: actions charging directors with waste of corporate assets through mismanagement or breach of fiduciary duty, *Cohen* v. *Young*, 127 F. 2d 721 (6th Cir. 1942), *Converse* v. *United Shoe Mach. Co.*, 209 Mass. 539, 95 N.E. 929 (1911); actions attacking contracts as *ultra vires* the corporation, *Dickinson* v. *Consolidated Traction Co.*, 114 F. 232 (C.C.D.N.J. 1902), aff'd 119 Fed. 871 (3d Cir. 1902), *cert. denied*, 191 U.S. 567 (1903); and actions against outsiders for wrongs against the corporation, *Green* v. *Victor Talking Mach. Co.*, 24 F. 2d 378 (2nd Cir. 1928) (dictum), *cert. denied*, 278 U.S. 602 (1928).

Although the plaintiff alleges that the false and misleading proxy statement was used to deprive him of his pre-emptive rights, this is really surplusage to Count II of his complaint. Count II asks for damages for the violation of Section 14(a) and that the merger be declared void. If the proxy was in fact false and misleading, the individual defendants may be liable in damages to the Company. Since it is in the first instance the Company which suffered, if anyone did, the proper way in which to make the plaintiff whole is to make Case whole. Nothing would be gained but confusion and injustice to the creditors and present shareholders of Case by attempting to allocate damages from the Company to the members of the plaintiff's so-called class. By analogy to actions brought to void *ultra vires* contracts, it is even clearer that if anyone has a right to have the merger voided, it is the Case Company, which plaintiff alleges has been victimized, and that if the plaintiff has any colorable ground for asserting such a right, it is only on behalf of the Company.

The security for expenses statute confers a right upon Wisconsin corporations in exercise of the state's power to regulate the incidents of the stockholder-corporation re-

lationship. The Wisconsin Court has held that the Wisconsin Corporation Law is a part of the stockholder's contract with the corporation. *Milwaukee Sanitarium* v. *Swift*, 238 Wis. 628, 300 N.W. 760 (1941); *Johnson* v. *Bradley Knitting Company*, 228 Wis. 566, 280 N.W. 688 (1938).

Cohen v. *Beneficial Industrial Loan Corporation*, 337 U.S. 541 (1949), held that federal courts must apply state security for expenses statutes in diversity cases. Mr. Justice Jackson, speaking for the Court, held that the states have plenary power over derivative actions:

> "The very nature of the stockholder's derivative action makes it one in the regulation of which the legislature of a state has wide powers. Whatever theory one may hold as to the nature of the corporate entity, it remains a wholly artificial creation whose internal relations between management and stockholders are dependent upon state law and may be subject to most complete and penetrating regulation, either by public authority or by some form of stockholder action.
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> * * *
>
> We conclude that the state has plenary power over this type of litigation."

337 U.S. 541, 549-50 (1949)

Cohen went on to hold that the security for expenses statute created new substantive rights and liabilities, and that it had to be enforced by the federal courts in diversity actions, upon the authority of *Erie R. Co.* v. *Tompkins*, 304 U.S. 64 (1938). See also *York* v. *Guaranty Trust Company*, 326 U.S. 99 (1945).

Were the plaintiff here not attempting to sue on a federally-created right, *Cohen* would conclude the matter. However, the fact that the plaintiff is attempting to invoke the federal question jurisdiction of the Court does not *ipso facto* make the statute inapplicable, as the Seventh Circuit

held. In *Levitt* v. *Johnson,* CCH Fed. Sec. L. Rep. Par. 91,304 (D.C. Mass. 1963), Judge Wyzanski relied in part upon the reasoning of Mr. Justice Brandeis and Mr. Justice Douglas in holding that a Massachusetts statute regulating minority shareholders' derivative suits applied in an action under the Investment Companies Act (15 U.S.C. §80a-1, *et seq.*):

> "Reference to the law of the state of incorporation to determine whether a stockholder has the substantive right to bring a derivative action for his corporation remains appropriate even if the claim which the corporation has against the alleged wrongdoer is based on a federal statute. It is this principle which explains the opinion of Justice Brandeis in United Copper Co. v. Amal. Copper Co., 244 U.S. 261 that 'The fact that the cause of action is based on the Sherman Law does not limit the discretion of the directors or the power of the body of stockholders; nor does it give to individual stockholders the right to interfere with the internal management of the corporation.'. That principle also explains Justice Douglas's opinion in Price v. Gurney, 324 U.S. 100, 107 that 'nowhere is there any indication that Congress bestowed on the bankruptcy court jurisdiction to determine that those who in fact do not have the authority to speak for the corporation as a matter of local law are entitled to be given such authority and therefore should be empowered to file a petition in behalf of the corporation.'"

The Seventh Circuit held that, because Count II of the complaint, in the court's judgment, stated a federal cause of action, the Wisconsin security for expenses statute (Section 180.405(4), Wisconsin Statutes) did not apply to it. (R. 234). In reaching this decision it relied upon *McClure* v. *Borne Chemical Company,* 292 F. 2d 824 (3d Cir. 1961), *cert. denied* 368 U.S. 939 (1962), and *Fielding*

v. *Allen*, 181 F. 2d 163 (2d Cir. 1950). *McClure* and *Fielding* both held that *Payne* v. *Hook*, 7 Wall. 425 (1869), foreclosed application of state security for expenses statutes in federal equity cases. This was error, because *Payne* v. *Hook* was overruled by *Mason* v. *United States*, 260 U.S. 545 (1922), to the extent it held that federal equity jurisdiction was not subject to limitation by state law. See 1A Moore's Federal Practice, §0.305(1), at p. 3051. *Mason* held that the Rules of Decision Act of 1789 applies to suits in equity as well as actions at law.

As amended in 1948, the Rules of Decision Act reads as follows:

> "The laws of the several states, except where the Constitution or treaties of the United States or Acts of Congress otherwise require or provide, shall be regarded as rules of decision in civil actions in the courts of the United States, in cases where they apply."

28 U.S.C. §1652 (1948)

The Rules of Decision Act gives statutory recognition to what has been termed the interstitial nature of federal law.

> "Federal legislation, on the whole, has been conceived and drafted on an *ad hoc* basis to accomplish limited objectives. It builds upon legal relationships established by the states, altering or supplanting them only so far as necessary for the special purpose. Congress acts, in short, against the background of the total *corpus juris* of the states in much the way that a state legislature acts against the background of the common law, assumed to govern unless changed by legislation."

Hart and Wechsler, *The Federal Courts and the Federal System*, p. 435 (1953)

To remain consistent with the interstitial rationale noted by the commentators and the courts, and embodied in the Rules of Decision Act, the Court should recognize and enforce the state-created right unless to do so would unduly impair the pertinent federal policy:

> "Federal policy should be effectuated by discriminate use of the [Rules of Decision] act, while in the absence of overriding federal policy effect should be given to state-created rights as such rights would be enforced in the state of origin."

Hill, "State Procedural Law in Federal Non-diversity Litigation", 69 Harv. L. Rev. 66, 113 (1955)

When a federal statute enters a field, it does not necessarily abrogate all other related law, or occupy the field; even where it does, there remains the problem of defining the limits of the field. Federal law should not displace any more state or common law than is necessary to effectuate federal policy.

> ". . . the state law has been absorbed, as it were, as the governing federal rule not because state law was the source of the right but because recognition of state interests was not deemed inconsistent with federal policy.
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> * * *
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> In the absence of explicit legislative policy cutting across state interests, we draw upon a general principle that the beneficiaries of federal rights are not to have a privileged position . . ."

Board of Commissioners of Jackson County v. *United States,* 308 U.S. 343, 350-52 (1939), Frankfurter, J.

McClure, supra, also erred in finding that there is an explicit policy in the Securities Exchange Act which cuts across state interests, and that recognition of state security for expenses legislation was inconsistent with the policy

of the Act and Federal Rule 23 (c). In *Cohen* v. *Beneficial Industrial Loan Co.*, 337 U.S. 541 (1949), at page 556, Mr. Justice Jackson held that the New Jersey security for costs statute did not conflict with Rule 23 (c):

> "[The provisions of Rule 23(c)] neither create nor exempt from liabilities, but require complete disclosure to the court and notice to the parties in interest. None conflict with the statute in question and all may be observed by a federal court, even if not applicable in state court."

It is equally clear that state security for expenses statutes do not conflict with the policy of the Securities Exchange Act. In fact, that Act expresses a positive policy in favor of security for expenses. Section 18(a) (15 U.S.C. §78r, see appendix A), creates a private action for damages in favor of any person who purchases or sells any security in reliance upon a false or misleading statement made in any application, report or document (apparently including proxy statements), at a price affected by such statement, and it expressly provides as follows:

> "In any such suit the court may, in its discretion, require an undertaking for the payment of the costs of such suit, and assess reasonable costs, including reasonable attorney's fees against either party litigant."[2]

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[2] Similar security for expenses provisions exist in other statutes regulating securities. See *e.g.* Section 11(e) of the Securities Act (15 U.S.C. §77k(e)); Section 16(a) of the Public Utilities Holding Company Act (15 U.S.C. 79p(a)); and Section 323(a) of the Trust Indenture Act (15 U.S.C. §77www(a)).

Clearly, where the relief and the liability demanded are so much more drastic, as is true of the plaintiff's action, the policy expressed in Section 18(a) should apply *a fortiori*. Since the two relevant expressions of federal policy both strongly favor the policy of the Wisconsin security for expenses statute, the right created by the Wisconsin statute should not be abrogated by federal law.

CONCLUSION.

For the reasons stated, the Court should reverse the Court of Appeals and reinstate the order of the District Court, insofar as it dismissed Count II of the complaint.

Respectfully submitted,

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